

is reported in 367 U.S. 911, rehearing was denied and per curiam order amended at 368 U.S. 873.

The prior opinion of the Court of Appeals for the Eighth Circuit dated October 19, 1960, is reported at 283 F.2d 234, and is printed as Appendix B hereto (p. 2a).

The Findings of Fact and Opinion of the Tax Court of the United States is reported in 32 T.C. 1271. (R. 203-221.)*

JURISDICTION

The judgment of the Court of Appeals was entered December 15, 1961. (Appendix C, p. 17a). The jurisdiction of this Court is invoked under 28 U.S.C. section 1254.

QUESTION PRESENTED

The sole question for decision is:

Is income realized merely by signing a contract for the giving of dancing lessons?

The taxpayers maintain that income does not arise at the time the executory contracts are signed. Rather income arises at the time it is earned by the giving of the lessons under the accrual method of accounting.

The Commissioner says income is realized equal to the face amount of the executory contract at the time the contract is signed to teach dancing lessons in the future.

* "R." references are to the record of the proceedings before the Tax Court, which have been filed as a part of the record in this Court.

STATUTE AND REGULATIONS INVOLVED

The pertinent provisions of the Internal Revenue Code of 1939 and of the Treasury Regulations are set forth in Appendix D. (pp. 18a-23a).

STATEMENT

The pertinent facts may be summarized as follows (App. pp. 3a-6a):

Taxpayers, husband and wife, on June 18, 1946, formed a partnership known as Arthur Murray Dance Studio for the purpose of conducting and operating dance studios authorized by certain franchise agreements entered into with Arthur Murray, Inc., of New York City. The venture was carried into effect and the partnership operated studios in the States of Nebraska, Iowa and South Dakota, for the specific purpose of teaching private ballroom dancing to individual students. (R. 205-206)

Basically, there were two kinds of contracts entered into between the partnership and students desiring dancing instructions. Under one type, a portion of the total tuition was paid in cash when the contract was signed, and the balance paid subsequently in installments. Under the other, a portion of the down payment was paid in cash at the time the contract was entered into, and the balance of the down payment was to be paid in installments, the remainder of the contract price being evidenced by a negotiable note taken from the student, payable in designated installments in accordance with the terms of the note. Under the contract the student agreed to take a designated number of hours of dancing lessons and pay therefor the amount specified as tuition. All types of contracts contained

a non-cancellable provision and provided that the student should not be relieved of his obligation to pay the tuition agreed upon. The hours of lessons or instructions contracted for ranged from 5 to 1,000 or 1,200. Some of the contracts were for lifetime courses which meant that, over and above 1,200 specified hours, the student was entitled to 2 hours of lessons per month plus two parties a year for life. By explicit terms, the studio was required to give the number of hours of instruction agreed upon. The contracts, however, did not schedule the dates when the studio was required to give and the student was to receive instructions, this detail being arranged and agreed upon from time to time as lessons were given. (R. 207-208) However, every contract specifically provided for an expiration date. (R. 108, Exs. 15-C to 20-T, inclusive). Under many of the contracts, lessons extended beyond the fiscal year in which the contract had its inception. (R. 208)

Notes taken from students were transferred with full recourse to a local bank, which at the time of acquiring a note would deduct therefrom the interest charges and give approximately 50 per cent of the balance of the note to petitioners. Installment payments by students on the remainder of the note were held by the bank in a reserve account, but this reserve was not available to petitioners until the note was paid in full by the student, after which the reserve was transferred to the partnership's general bank account. (R. 208)

A sizeable number of contracts was cancelled annually, the non-cancellable provision to the contrary notwithstanding. In its opinion, the Tax Court found

IN THE
Supreme Court of the United States

October Term, 1964

No. **793**

MARK E. SCHULDE AND MARGARET SCHULDE

COMMISSIONER OF INTERNAL REVENUE

**PETITION FOR WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS FOR
THE EIGHTH CIRCUIT**

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IN THE
Supreme Court of the United States

OCTOBER TERM, 1961

No.

MARK E. SCHULDE AND MARZAH SCHULDE

v.

COMMISSIONER OF INTERNAL REVENUE

**PETITION FOR WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS FOR
THE EIGHTH CIRCUIT**

Petitioners pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Eighth Circuit entered December 15, 1961.

PRIOR OPINIONS

The per curiam opinion of the Court of Appeals on remand dated December 15, 1961, is unreported and is printed in Appendix A hereto (p. 1a).

The per curiam opinion of this Court dated June 19, 1961 granting certiorari and remanding the case

that "cancellations were considerable in amount," noting that records of the partnership disclosed that cancellations for the respective years involved were 17 per cent, 15 per cent, and 19 per cent of sales for the respective years.¹ (R. 215)

A complete double entry bookkeeping system was installed for the partnership by a certified public accounting firm at the time that the partnership was organized, and an accrual system of accounting was employed, with the fiscal year ending March 31. This accounting system was used continually and consistently from the time the partnership was formed. Additionally, individual student record cards were maintained, listing all pertinent information such as name and address of student, type of contract, hours involved, total contract price, history of lessons taught, and payments made under the contract. (R. 209).

When a contract was entered into with a student, the "deferred income" account was credited with the total contract price. At the close of each fiscal year, the student record cards were analyzed and determination was made of the number of hours of lessons taught which, multiplied by the rate per hour of each contract, gave the amount of income earned. The deferred income account was then reduced by that amount and an earned income account increased by the same amount. Earned income thus arrived at was reported as income on the partnership's tax return. If there was any gain resulting from the cancellation of a con-

¹ Petitioners contend that the Tax Court's percentages of cancellation are inaccurate; sales in the amount of approximately 28.4 per cent, 14.1 per cent and 25.2 per cent were cancelled in the fiscal years 1952, 1953 and 1954. (R. 152; Pet. Ex. 24)

tract, this amount was also considered as taxable income and reported as such. (R. 209-210)²

Three qualified accounting experts testified that the system of accounting employed by taxpayers did reflect true income and was the only method which would do so. The Tax Court made no finding that taxpayers' system of accounting did not reflect their true income. (R. 205-214, 154-156, 190-192, 199-200.)

Under the Commissioner's method of computing income, this successful and growing business would have had an actual cash deficit of \$15,259.92 at the end of the fiscal year ended March 31, 1954. As of the same date, the partnership was under the contractual obligation to teach 31,677 hours of dancing which would have cost over \$250,000. (R. 167-169.)

The Commissioner determined that the entire amount of the contract price was income in the year in which the contract was entered into. (R. 215). Accordingly, in his notices of deficiency he increased the ordinary net income of the partnership for the fiscal years involved by the amounts of the increases in the "deferred income" account in those years. (R. 213). The deficiencies resulting from such increases in the deferred income account in the fiscal years ended March 31, 1952, 1953 and 1954 are as follows: \$24,602.22 in 1952, \$104,798.41 in 1953, and \$12,797.97 in 1954. (R. 213). The Tax Court, three Judges dissenting, sustained the Commissioner's determination through application of the "claim of right doctrine," meaning

² Detailed schedules which correctly and precisely reflect the result of the partnership's accrual system of accounting during the years in question appear in the findings of fact of the Tax Court. (R. 210-214.)

that, for income tax purposes, the full amount of a contract price had to be returned as income in the year in which the contract was entered into, irrespective of the amount of money collected and irrespective of the actual rendering of service or of any obligation on the part of the partnership to render services under the contract in years subsequent to the year in which the agreement was made. (R. 203-221). The Court of Appeals, one Judge dissenting, on October 19, 1960, reversed the Tax Court. (App. pp. 3a-16a). The Court in part stated: (App. p. 13a)

"Even assuming arguendo that petitioners received cash payment in full at the time of contracting, the receipt of the funds could not be considered to be earned until petitioners had discharged their liabilities under the contract. Under their method of accounting, established when the partnership was formed and continually employed thereafter, petitioners reported as income in their tax returns such portion of the total amount received, as under their system of accounting had been earned, deferring the remainder of the amount received for inclusion in the year or years in which the remainder of their liability was discharged. Such system seems eminently designed to reflect true income."

"This is not a situation where taxpayers are attempting to change their method of accounting. See *Beaton v. Helvering*, 291 U.S. 193, 197; *United States v. Anderson*, 269 U.S. 192, 197; *Beaton Publishing Co. v. Commissioner of Internal Revenue*, supra, at pp. 791-792. Three qualified experts testified that the system here employed did reflect true income and in fact was the only method which would do so."

On June 19, 1961, this Court granted the Commissioner's petition for certiorari, and in a per curiam decision vacated the judgment and remanded the case.

in the light of *American Automobile Association v. United States*, 367 U.S. 687 (1961). On petition for rehearing this Court, on October 9, 1961, denied the petition for a rehearing and amended its per curiam order by remanding the case "for further consideration in light of *American Automobile Association v. United States*." On December 15, 1961, the Court of Appeals in a per curiam opinion held that "In the light of that case [*American Automobile Association*] we have carefully examined and considered petitioners' method of accrual accounting and are convinced that such method does not, for income tax purposes clearly reflect income," and vacated its previous judgment and affirmed the decision of the Tax Court.

REASONS FOR GRANTING THE WRIT

1. The Court of Appeals erred in holding that in the light of the case of *American Automobile Association*, the taxpayer's method of accrual accounting does not for income tax purposes clearly reflect income. The Court of Appeals has misapplied the holding of this Court in the *American Automobile Association* case to the entirely different factual situation than that which exists in the case at bar. There are many important factual distinctions between the *American Automobile Association* case and the case at bar.

(a) In the case at bar, the Tax Court held that the entire contract price is income when the contract was signed even though the contracts were executory in that many payments were not to be made until a subsequent taxable year and were not due until such subsequent year. (See dissenting opinion of three Tax Court Judges. R. 219-221.) In addition, many of the dancing lessons were not to be given until a subse-

quent year. In the *American Automobile Association* case the Court was dealing only with actual cash money paid to the Association for which there may or may not have been future services required.

The taxpayers derive income from the teaching of ballroom dancing, not from the signing of contracts. The signing of an executory contract, wherein a student promises to pay for lessons to be given in the future, does not meet the definition of when income accrues as stated in *Spring City Foundry Co. v. Commissioner*, 292 U.S. 182, 184, as follows:

"Keeping accounts and making returns on the accrual basis, as distinguished from the cash basis, import that it is the *right* to receive and not the actual receipt that determines the inclusion of the amount in gross income. When the right to receive an amount becomes fixed, the right accrues."

While the contracts were executory, no income was earned and, consequently could not accrue. *United States v. Anderson*, (1926) 269 U.S. 422. The event giving rise to the income was the giving of the dancing lessons. Until the lessons were given there was no "right to receive" an amount which had become fixed within the meaning of the accrual accounting concept. Cf. *Spring City Foundry Co. v. Commissioner*, 292 U.S. 182. By taking into account gross income in the year earned and the expense in the year incurred, there was a matching of gross income with related costs and expense applicable to the process of earning that income and therefore a true determination of taxpayers' net income.

(b) To the extent that cash was actually received on the dancing contracts during the year, the important

factual distinctions are that in the case at bar (1) there was no pro rata allocation of income to periods on a time elapsed basis; (2) there was no pooling of expenses or a deduction of expenses on a pro rata basis; (3) there was no computation of profits based on average experience in rendering services or performance, and (4) there was no selling of availability of services. In the case at bar, (1) income is returned in the year of actual performance; (2) expenses are deducted when incurred; (3) profit is computed on the basis of actual events or transactions and the exchange of values, and (4) actual services are sold which can be identified for each contract as to the amount of performance rendered and the amount of performance yet to be rendered. Consequently, the case at bar falls within the rules of *Beacon Publishing Company v. Commissioner*, (C.A. 10, 1955) 218 F. 2d 697, and *Schuessler v. Commissioner*, (C.A. 5, 1956) 230 F. 2d 722, because the studio rendered actual dancing instructions to its students on fixed dates as scheduled, in accordance with the terms of the contracts. This is the principle on which this Court distinguished the *Automobile Club of Michigan* case and the *American Automobile Association* case from the *Beacon* and *Schuessler* cases.

In the *American Automobile Association* case, the taxpayer failed to prove that the method of deferral used bore any significant relation to the services to be performed in the future. In the instant case the deferral bears a direct relation to the services to be performed and which are in fact required to be performed under the terms of the contract. The studio's obligation to provide services subsequent to the tax year was fixed, definite and certain and furthermore

was identifiable as to untaught hours and unearned contract amount for each student contract outstanding at the end of the year.

2. The decision below is in conflict in principle with the decision of this Court in *United States v. Anderson*, (1926) 269 U.S. 422, where the purpose of the accrual method of accounting was stated as follows:

* * * * It was to enable taxpayers to keep their books and make their returns according to scientific accounting principles, by charging against income earned during the taxable period, the expenses incurred in and properly attributable to the process of earning income during that period:
* * * *

The decision below is also in conflict with the decisions of the Fifth and Tenth Circuits in the cases of *Schuessler v. Commissioner*, (C.A. 5; 1956) 230 F. 2d 722, and *Beacon Publishing Company v. Commissioner*, (C.A. 10, 1955) 218 F. 2d 697. In *Automobile Club of Michigan v. Commissioner*, (1957) 353 U.S. 180, this Court distinguished the *Beacon* and *Schuessler* cases from the *Automobile Club of Michigan* on its facts by pointing out that performance of the subscription, in those cases, was, in part, necessarily deferred until the publication dates after the tax year. In *Schuessler* it was pointed out that performance of the service agreement required the taxpayer to furnish services at specified times in years subsequent to the tax year. In the *Automobile Club* cases substantially all the services were performed only upon a member's demand and the taxpayer's performance was not related to fixed dates after the tax year. In the case at bar, the dancing students do not buy the availability of services. They buy the actual dancing instruction itself. In the

Automobile Club of Michigan v. Commissioner, 353 U.S. 180, the Court found that (p. 189) "the pro rata allocation of the membership dues in monthly amounts is purely artificial and bears no relation to the services which petitioner may in fact be called upon to render for the member." This is not the situation in the case at bar. The Court of Appeals in its original opinion in the case at bar pointed this out and said: (App. 14a)

"The facts before us are distinguishable. Here, petitioners' obligation to provide services subsequent to the tax year was fixed, definite and certain, thereby effectively rebutting any contention that petitioners' method of deferral was purely artificial. The system and method of accounting on an accrual basis with the deferral of income so that it could be closely matched to the corresponding expenses, was designed to clearly reflect petitioners' true income within the meaning of the applicable statutes and regulations. As pointed out in the *Beacon* and *Schuessler* cases, any other method would result in a distortion of true income."

3. The problems presented for review by this Court are of substantial and continuing importance, both to the government and to taxpayers. This is true because most American business concerns use the accrual system of accounting. In any case in which it is necessary to use an inventory the regulations specifically require that taxpayers use the accrual system. Treas. Reg. 118, sec. 39.41-2. If the *American Automobile Association* decision is construed to mean, as the Courts below have construed it, that the full amounts of the contracts are income and taxable in the year the contracts are signed irrespective of when payment is made

or is due to be made, and irrespective of time of performance by the taxpayer under the contract it will raise havoc with American business. Illustrations are service contracts for long term maintenance service, contracts providing advertising services over extended periods, or manufacturers and merchants who receive sales contracts in advance of the shipment or delivery of their products, or, as pointed out in Judge Pierce's dissenting opinion in the Tax Court, the mere signing of a lease might hereafter result in accruing as income at the time the lease was executed all rental payments contracted to be made in subsequent years under such lease. If the Eighth Circuit's interpretation is permitted to stand, expenses will be incurred in performing contracts when no "income" will be available to offset the expenses, and more importantly, no income will have been earned under such contracts. Such a rule does violence, not only with the accrual method of accounting now used by most American business concerns, but to the Internal Revenue Code, Treasury Regulations and the rule of *United States v. Anderson*, (1926) 269 U.S. 422, which expresses the rule of accrual accounting that expenses incurred in earning income should be charged against income earned.

CONCLUSION

For the reasons stated, the petition for a writ of certiorari should be granted.

Respectfully submitted,

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